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Thailand's Banking Sector: 1988-2003
Government, politics and competition

by

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Introduction

Since the beginning of Thailand's modern banking industry, marked by the Commercial Banking Act of 1962, until the military coup of October 2006, the sector has undergone several economic shocks and political changes. In the last twenty years Thailand has had three constitutions, the most recent is still being drafted (2007), two military coups and seven prime ministers. The economy was the fastest growing in the world from 1986 to 1990 and also the first in a long succession of victims of the Asian financial crisis in 1997. Yet through all these changes Thailand's banks have remained politically powerful and, for the most part, intact. This paper investigates relations between Thailand's financial sector, more specifically the Thai-owned banks, and Thailand's government.

Perhaps the easiest way to understand government-banking relations is to examine economic shocks and political changes throughout a specified period of time. During times of political and economic change the actions of Thai banks and the Thai government are more clearly documented and scrutinized by academics and journalists. Drawing from their accounts I attempt to illustrate the most significant changes to the government-banking relationship over the last 25 years.

Thailand's banks have been involved in politics and policy making since their inception in the 1950s. Recent changes to Thailand's banking sector—specifically liberalization, competition and crisis—began in the mid 1980s when the Thailand's business sector, led by the banks, lobbied for reorienting Thailand's economy towards export driven growth. The reorientation sparked a major investment boom which boosted profitability and growth in the banking sector. However, the export boom also integrated

Thailand into the global economy which brought about new pressures. As an international export base Thailand's image abroad became increasingly important to the success of their export model. Financial liberalization was seen as an integral step for Thailand to remain competitive in the future.

Thailand's financial liberalization began in 1988 when the government loosened interest rate ceilings on deposits. They subsequently relaxed restrictions on international borrowing by giving banks increased access to international capital. With reduced control over capital flows, the Bank of Thailand lost its ability to maintain its traditionally conservative approach to monetary policy. Access to international capital flooded Thailand with international debt. Export revenues were needed to pay interest on international debts. In 1997 a fall in export revenue meant Thailand could not pay its debts and drove the economy to a halt. As a result banks were insolvent and they were vulnerable to take over. They resisted equity sell offs and feared losing control but the crisis proved too severe and many banking families lost majority equity share of their banks.

Despite all the changes in Thailand's government-banking relationship banks have consistently resisted government regulation. How were Thailand's banks so resilient despite regulatory changes, external shocks and political interventions?

Background – pre 1980

In *Bankers and Bureaucrats Capital and the Role of the State in Thailand*, Kevin Hewison offers a historical perspective on the growth of capital in Thailand. Hewison explains how Thailand's banks and the families that ran them, sat at the core of a small but powerful "capital class" that emerged during the second half of the 20th century. In

the second half of the 20th century Thailand experienced a phenomenal economic boom. It was one of the fastest growing nations in the world with GDP growth exceeding 7% per annum for nearly 40 years.[1]

In the 1950s and 1960s Thai banks used personal relationships with government officials and politicians to hedge against potential bank failures or other problems. Although personal relationships continue to integrate the banks with politics, government and regulators, these early decades were undoubtedly more overt than future iterations of banking-government connections. In addition to simply providing loans with favorable terms to officials, banking families placed military officers and government officials directly on the board of directors.

In 1953 Bangkok Bank's personal connections in government caught the attention of media. During 1953 Bangkok Bank was unable to meet withdrawal demand and feared that a run on the bank would push the bank to fail. To save the bank, the Ministry of Economic Affairs invested thirty million baht cash. In return they held a 60% equity stake. Two years later, when the bank had fully recovered, the Ministry sold its shares back to Chin Sophonpanich, the owner of Bangkok Bank. It was not common for the government to invest in a bank but in this case the Minister of Economic Affairs, Siri Siriyothin, sat on the board of directors. When the Ministry of Economic Affairs invested in Bangkok Bank they said the purchase was to help protect Thai banks from foreign competition. After selling the shares back to Chin Sophonpanich the media questioned the government. The media asked why the government sold shares back to the original

[1] Siamwalla, 2001 p.1

owners, so Siri explained that it was not the place of government to involve itself in the private sector. Basically, the government bailed out Bangkok Bank.[2]

The relationship between the government and Thai banks became more formalized with the enactment of the Commercial Banking Act of 1962. In the early 1960s Thailand needed capital to fund its economic growth. To facilitate investment the government needed banks to mobilize domestic savings. The government encouraged banks to expand their branch networks into the provinces. By expanding branch networks into the provinces banks could collect deposits and increase the pool of capital available for investment. The expansion however, was costly so the banks asked for protection. Banks claimed if new firms were to enter the provinces before Thai banks could pay off the expenses incurred for expansion they would be at a competitive disadvantage.

In 1962 the government and the banks came to an agreement. The banks would expand their branch network to mobilize savings and the government would restrict the issuance of new banking licenses to protect the banks from competition. The agreement was the Commercial Banking Act of 1962.[3]

Both the government and Thailand's banks benefited from the agreement. Thailand's banks were protected from foreign competition; from 1965 to 1990 just one commercial banking license was granted. The pool of capital available for investment increased dramatically. As a result of the expansion of branch networks extending into the provinces, domestic savings grew. Between 1960 and 1982, bank deposits went from just 5.6B Baht to 308B Baht. With domestic savings mobilized the amount of credit in

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[2] Hewison, 1989 p.193-5
[3] Hewison, 1989

the banking system also grew. In the same period, loans grew from 5.3B Baht to 299B Baht.[4]

In addition to limiting banking licenses the Thai government limited access to more traditional methods of savings. At that time, most Thais still used pawnshops to convert their cash savings into gold and silver. Tangible assets held their value better than cash. By limiting the expansion of pawnshops Thais had fewer choices of where they could put their savings. It took a concerted effort of both the government and the banks to convince the public to put money into the banking system. Together they created the consumer banking market in Thailand.

The Act helped build public confidence in the financial system. It convinced people that cash deposits were safe and that banks would lead Thailand's economic growth into the future. The Bank of Thailand explained the purpose of the Act was to "regulate the banking business and safeguard public interest."[5]

More generally Thailand wanted to and needed to modernize the financial system. The Act formalized regulatory framework. Banking sector oversight was assigned solely to the Bank of Thailand. The Bank of Thailand could set interest rate ceilings and set cash reserve ratios. They controlled the flow of international capital using various mechanisms, e.g. withholding tax. To reduce corruption, banks were no longer allowed to extend loans to their directors. Despite the centralization of regulatory power over the banking sector, the Bank of Thailand still had to contend with an equally, if not more, powerful banking sector.

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[4] Hewison, 1989 p.177
[5] Thanakhan Haeng Prathet, 1992

Ownership in the banking sector was extremely concentrated. There were only sixteen banks all of which had a single family network with a controlling stake. Within the group of sixteen, just four banks, Bangkok Bank, Thai Farmers Bank, Krungthai Bank and Siam Commercial Bank dominated the Thai Bankers Association.[6] Linkages between banks were further strengthened through marriage, social groups and schooling. These banks were so concentrated that they influenced interest rates, "important decisions regarding interest rates and other price-setting decisions in the money market [were] influenced by these four banks, through the Thai Bankers Association."[7].

The power of Thai Bankers Association over the Bank of Thailand was explained by Apichat Satitniramai in a PhD thesis cited in Polsiri and Wiwattanakantang, "the bankers had immense power over the financial supervisory authority during the period 1942–1997. The bankers lobbied the MOF as well as the BOT officials via the powerful Thai Banker Association. The bankers' influence on the BOT had undermined its supervisory role. For example, when the BOT tried to impose the prudential standard capital adequacy ratio in 1962, 1979, and 1992, the bankers negotiated for lower ratios and won every time. In 1992, the Thai Banker Association managed to have the capital adequacy ratio reduced from the original requirement ratio of 8% to 7%, and the second tier capital reduced from the original requirement ratio of 3% to 2%."[8]

The Commercial Banking Act of 1962 strengthened the power of banks. Using the Thai Bankers Association they were able to bargain with the government over monetary policies as well as lobby for protection. By operating in such a protected

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[6] By 1990, Bangkok Bank, Thai Farmers Bank, Krungthai Bank and Siam Commercial Bank held 70% market share of all deposits and credits. Warr & Nidhiprabha, 1996 p.40
[7] Warr & Nidhiprabha, 1996 p.40
[8] Polsiri & Wiwattanakantang, 2006 p. 347

market Thai banks faced little competition and never became efficient. After the 1997 crisis Ammar Siamwalla reflected on the inefficiencies of the banking industry, "the allocation of capital in Thailand...followed a broadly laissez-faire process, with the banks playing a central role... [Banks] did not have the technical competence to evaluate long-term loans... the capital market in Thailand had no mechanism to guide the allocation of capital in a disciplined way."[9]

1980-88 Prem Tinsulanonda

Macroeconomic policy

Thailand had always been conservative in its management of the economy. Their conservatism made it difficult to make changes in macroeconomic strategy. Of primary concern was controlling inflation. This was done by setting interest rates, using a fixed exchange rate scheme and maintaining a budget surplus. The conservative approach had its roots dating back to World War II when Thailand switched foreign reserves from U.S. Dollars and British Pounds to Japanese Yen and Japanese government bonds. Thailand was forced into switching reserves because the Allies had frozen their overseas accounts in protest of their connections with the Japanese.[10]

At the end of the war the Japanese Yen and government bonds lost their value making Thailand's foreign reserves worthless. The worthless Yen caused the Thai Baht to depreciate spurring hyper-inflation. The effects of inflation were devastating to Thailand's economy and had lasting effects on the government. As a result of the hyper

[9] Ammar, 2001 p.6
[10] Warr & Nidhiprabha, 1996 p.11-13

inflation following World War II, the Thai government considered controlling inflation the primary concern of its macroeconomic policy.

Politics

In March 1980 General Prem Tinsulanonda became Prime Minister of Thailand. The Prem period represented was called "semidemocracy" (Chai-anan Samudavanija) and "quasi-civilian government" (Warr and Bhanupong) due to the mixture of elected and non-elected officials operating within government. Prem was not an elected politician but he presided over an elected parliament. The parliament was broken into many factions and was frequently bogged down with internal fighting. The divisions and persistent bickering weakened their bargaining leverage vis-à-vis Prem and the military. As a result of their relative weakness Prem was able to strike a power balance between the parliamentary factions and himself.

To balance power Prem had to assuage parliamentary politicians eager to access lucrative government contracts. The politicians needed to channel money to their constituents to maintain their electoral power. So Prem placed parliament in control of ministries like Commerce, Education and Industry where they could access contracts.

The increased access to government posts provided to the elected parliament freed Prem to consolidate macroeconomic power. He centralized economic and financial control in the NESDB, the Ministry of Finance, Bureau of the Budget and the Bank of Thailand—the key institutions responsible for macroeconomic policy—and oversaw operations personally. He then filled those institutions with capable technocrats. The

technocrats, insulated from the narrow interests of elected politicians, were able to formulate economic strategy and pursue nationally focused policies.[11]

Banking Crisis

Thailand saw its first significant financial crisis in 1979 when it was discovered that a finance company was artificially inflating its own stock price by lending money to shell companies so they could buy the finance company's shares. As the scandal became known to the public investors began to lose confidence and the Stock Exchange of Thailand (SET) dropped rapidly. To fend off any runs on other finance companies the Bank of Thailand intervened. They revoked the finance company's trading license and extended low interest loans, via the government-owned Krung Thai bank, to depositors who had lost money.[12] One of the missions of the Bank of Thailand is to build and protect public trust in the financial system so in addition to helping depositors they also granted a three billion baht low interest loan to SET member firms to boost SET trading.[13]

Just before the 1979 crisis the government had passed the New Commercial Banking Act which was intended to, "change the fundamentals of bank regulation" giving the Bank of Thailand more power to regulate the financial sector.[14] The new act tried to broaden shareholder structures by limiting the percentage of shares that could be held by one party. The purpose for broadening ownership is to lessen the risk of moral hazard by having more parties involved in decision making. However, the new act did not have a significant effect as families retained their majority shares until 1997.

[11] Hicken see "policy-patronage compromise"
[12] Thanakhan haeng Prathet, 1992
[13] Thanakhan haeng Prathet, 1992
[14] Thanakhan haeng Prathet, 1992

The second major crisis began in 1983. This one was significantly worse because it penetrated beyond just finance companies and into big commercial banks. Following the 1979 crisis many finance companies delayed reforms and hoped for a quick economic recovery to reinvigorate the financial sector, especially the stock market, but the recovery came late. Depositors increasingly came looking to withdraw their funds so the finance companies tried to cover depositors' withdrawals by borrowing. Some even raised interest rates—which was illegal under the Bank of Thailand regulations—to defend against more withdrawals. Thais began to worry that their deposits were not safe and "In October 1983… [the finance companies] could not withstand a prolonged and continuous withdrawal… financial institutions… were particularly vulnerable to runs on deposits."[15] The Bank of Thailand responded with bailout packages for the finance companies. Finance company owners had to personally guarantee and provide collateral to receive bailout loans. Government officials were placed on boards and put into management positions. Finance companies deemed too distressed and beyond recovery were closed down and depositors were given government bonds in exchange for their deposits. In the end 20 finance companies were closed down.

Deposit runs had spilled over into the banking sector. But at the time the government had been encouraging banks to slow credit growth in an effort to reduce inflationary pressure. With low credit growth many banks had sufficient liquidity to fend off runs using their own reserves. Three banks had insufficient funds and sought government help: Asia Trust, First Bangkok and Siam City Bank. Asia Trust had to be shut down completely, their depositors were issued government bonds. First Bank and Siam City Bank were required to raise their capital adequacy ratios. To float them, the

[15] Thanakhan Haeng Prathet, 1992

Bank of Thailand provided soft loans despite public allegations of imprudent lending practices. In 1992 the Bank of Thailand said that, "any residue of problems which might remain today is largely insignificant; financial institutions are now more secure and ready as ever to play their part in promoting the country's economic development and prosperity." [16]

Business enters government – Banks argue for export strategy

The 1980s saw a political debate surrounding Thailand's macroeconomic policies. The business sector, led by banks, advocated for a strategic reorientation of the economy towards export-led growth. The military led government had been pursuing an import substitution policy whereby certain domestic industries were targeted for development. To help them along the government would levy tariffs on particular imports identified as substitutable thus creating a protected market for domestic firms to sell into. Pursuing an export growth strategy meant Thailand would be further integrated into the world economy and its ability to levy high tariffs would be diminished. Under this mindset policy makers were reluctant to shift to an export growth strategy. They worried pressures to open their market to imports would hurt nascent import substituting industries. Furthermore, to stay competitive in exports Thailand would have to lower the costs of imports, especially inputs needed to fuel export industries.

The export policy debate came to the forefront of Thailand's political landscape following the oil shock of 1979 because the oil shock revealed the vulnerability of Thailand's economy. Thailand was an oil importer and paid for oil imports by exporting agricultural committees. Not only were import prices increasing but export revenues were

[16] Thanakhan Haeng Prathet, 1992

decreasing. The oil price hike caused the US government to raise interest rates thus causing the dollar to appreciate. The US wanted to mitigate the oil price shock on American consumers and the American economy. Unfortunately for Thailand, the Baht was pegged to the dollar so it also appreciated. This made Thai commodities more expensive causing export revenues to fall.

With the costs of imports increasing and the revenues from exports decreasing, Thailand's current account (trade balance) went further into deficit.[17] The government tried to correct the balance of payments (current account) by controlling imports and exports. They used tariffs to stem the flow of imports and they promoted foreign revenue generating service exports, specifically overseas workers remittances and tourism. By impeding the flow of trade the government "[hit] the brakes on the economy." [18]

Thailand's efforts to adjust the current account by manipulating exports and imports took its toll on the fiscal budget. Soon they had used up their reserves and in 1981 Thailand was forced to take loans from the World Bank and IMF.

The government's handling of the oil shocks angered domestic business. Choking trade continued to hurt the economy and businesses began to lobby government to devalue the Baht and pursue an export growth strategy. The Thai Bankers Association led the lobbying effort for export oriented growth. Chatri Sophonpanich, the head of Bangkok Bank was quoted in 1981 saying, "A simple way to boost Thai exports is to do away with a myriad of government regulations...[These regulations] have led to the loss

[17] Thailand comfortably ran current account deficits from 1970-1996 (with the exception of one year, 1986). The oil shocks were different because the deficit was beyond the control of the government's budget and therefore could not be managed.
[18] Phongpaichit & Baker, 1997 p.147

of [our] market [share] to competitors. They have increased the costs of exporters and delayed our deliveries to importers."[19].

With Prem's technocrats protected the government response to business lobbying was cautious, conservative and slow. Finally in 1984 the government devalued the Baht and embraced export-led growth. It took three years for the Baht to depreciate by 20%. The Prem government offered tax benefits to exporting companies and reduced tariffs on capital inputs needed by export industries. The strategic shift was a boon for the economy, between 1985 and 1991 the value of exports quadrupled and by 1992 GDP had doubled.

Thailand's successful export-led boom was not just a result of macroeconomic strategy. The 1985 Plaza Accords sparked an appreciation of the Japanese Yen relative to the US dollar. The Thai Baht was still pegged to the dollar making Thai products cheaper in export markets. The strong Yen also increased the flow of investment from Japan. Additionally the price of oil fell—a key input for Thailand's export engine.[20]

The Prem period saw a shift to an export growth strategy for Thailand. The political debate surrounding that change revealed a shift in government business relations in Thailand. Business groups were becoming more powerful vis-à-vis the government. The debate on whether to devalue the Baht, "propelled business leaders to take a more aggressive role in politics." [21] Export growth strategy further integrated Thailand into the global economy. Although domestic savings were fueling the growth the export boom of the late 1980s Thailand increasingly looked towards international markets to further fund its spectacular boom.

[19] Anek L. 1992: 130 as cited in Phongpaichit & Baker, 1997 p150
[20] Phongpaichit & Baker, 1997 p.150-151
[21] Phongpaichit & Baker, 1997 p.149

Businesses lobby successfully

Not only did business groups successfully lobby the government under Prem but the banks averted a major crisis. The Bank of Thailand interventions in the banking sector during the 1980s set a precedent for government-banking relations. When banks were in financial trouble the Bank of Thailand kept them afloat with soft loans. Demands to increase capital adequacy ratios were followed by loan issuance. The banking sector felt assured of getting soft loans if they were in trouble.

Ammar Siamwalla said, "[the quick economic recovery and devaluation of the Baht] combined to minimize the losses to the Bank of Thailand and the financial system. Unfortunately, [the quick economic recovery] gave both the authorities and the financial community a misplaced confidence in the general soundness of the Thai financial system and their ability to tackle another crisis, should one arise."[22] Even with regulatory structure in place and key-economic institutions insulated from particularistic interests of politicians, the Bank of Thailand had difficulty enforcing regulation on the banking sector. In times of crisis the Bank of Thailand provided soft loans, bailed out banks and even injected pubic money into the stock market.

Siamwalla questioned how Thailand's economic growth could be so great when the financial sector had been so ineffective at allocating capital.[23] The financial sector did not drive economic growth but rather facilitated growth. Factors like urban migration and demographics allowed Thailand to continuously supply labor resources to the growing export sector in the 1980s. Thailand's exports were not complex, most exports were primary goods and the manufacturing sector consisted mainly of assembly plants. With a

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[22] Ammar, 2001 p.9
[23] Ammar, 2001

relatively simple economy and a large supply of cost effective inputs like labor and primary goods, Thailand could grow without effectively allocating its capital.

1988-1992 – business led government

In 1988 General Prem stepped down from his position as Prime Minster under increasing pressure from parliament. There was a drawn out battle between the military and business backed politicians about a proposed constitutional amendment giving the military a permanent supervisory role in government. After several attempts at pushing through the amendment parliament grew impatient with the Army's insistence on amending the constitution. Realizing the growing power of parliament and their frustration with military involvement in government, Prem stepped down. He was replaced by Chatichai Choonhavan from the majority party, Chart Thai. Chatichai was the head of the Chart Thai party, a coalition of provincial politicians. This was the first time since the 1978 constitution that an elected politician became Prime Minister. The appointment of Chatichai also marked the true beginning of business led government. [24]

As the appointed leader Chatichai was responsible for keeping the coalition together. Coalition members demanded access to government resources so they could channel those resources to their consistencies. Chatichai met their demands by divvying up control of government resources. With Prem's technocrats out Chatichai placed politicians high up in government ministries. Politicians controlled budgets and macroeconomic policy. The balance of power during the Prem period that allowed technocrats to manage macroeconomic policy was gone. "Under Chatichai virtually every

[24] Hicken, 2001 p.173

Cabinet position went to an elected politician." Thailand's governing institutions were effectively politicized. [25]

The military saw Chatichai's government as corrupt and completely ineffective. He was in office for just three years before being forced out by a military coup. Chatichai's government had encroached on the "military's institutionalized control over the state."[26]

The military's frustration with Chatichai's government peaked during a budget dispute over arms purchases in 1991. The dispute coincided with new appointments in military leadership. The new leadership was aggressive and they wanted to reassert their power. With all the proliferation of corruption under Chatichai, the military used rampant corruption in the government as their justification for the coup. In November 1991 the military took control of the government.

The military immediately tried to roll back the influence of Chatichai's government. They appointed Anand Panyararchun, a respected businessman, as Prime Minister. Anand posted technocrats back to key economic positions. The military tried to bring back the power balance that had been so successful under Prem.

Anand was able to bring about some positive changes in macroeconomic policy. He aligned tax incentives and tariff reductions to further support the export growth strategy. He also re-launched needed infrastructure projects that were shelved under Chatichai. [27]

It was important for the military to retain the support of domestic capital, big business and big banks during the coup. The military and the banks had seen their

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[25] Hicken, 2001 p.174
[26] Phongpaichit & Baker, 1997 p.354
[27] Hicken, 2001 p.177

political power diluted by the rise of provincial politicians. Provincial politicians wielded the power of votes. Since most big business was in Bangkok they needed provincial politicians to represent their interests in government. But the disparate interests of provincial politics and weak party structure meant that coherent broad-based business initiatives were difficult to push through parliament. When the military was in power big business could cultivate relationships with military leaders to insure their interests were addressed in government.

Provincial politicians eroded the coherent macroeconomic focus that existed under General Prem. Initially the goals of Bangkok business and the military were aligned. The military wanted to regain political control and the old businesses, banks, wanted to keep their markets protected. Furthermore they both could benefit and profit from a consistent macro economic policy. GDP growth drove the demand for credit and thus created banking profits in Thailand.

The banks led Bangkok business into parliamentary politics during the 1970s by setting up political parties. Former Bangkok Bank chairman Boonchu Rojanastien was a key figure in the Social Action Party. As the party grew, it attracted more provincial politicians. By the 1980s MPs started breaking into factions driving Boonchu to leave the party. The military saw the rise of provincial politicians as threat. The 1991 coup was an attempt to purge government of provincial politicians. The military dissolved parliament and went after politicians on accounts of corruption. [28]

Thai banks made money by supplying capital to Thailand's growing economy. When the economy slowed so did the profits. The brief flashback to the early days of Thailand's banks' overt relationship with military generals did not last. The banks

[28] Phongpaichit & Baker, 1997 p.343-46

realized that to have a strong export driven economy Thailand needed a strong positive international image. Upon realizing these business risks banks discreetly called for an end to the coup. Once new elections were held, the banks offered up their own technocrats to fill key political positions.

The support of the military by big business began to sour after a violent clash between soldiers and street protestors in 1992. Since the economic reorientation of the mid 1980s Thailand's image had become increasingly important abroad. As international news media broadcast the atrocities a Bangkok business "association" which included prominent banks released a statement saying, "[they] request all parties to refrain from further all action that could lead to...political unrest...which adversely affects the country." [29]

The King finally stepped in to stop the violence causing the military to hold new elections. In 1992 the Democrat party won by a small margin and party leader Chuan Leekpai became Prime Minister. Chuan placed political allies back into key government institutions and positions, including some high profile bankers. Upon entering office Chuan appointed technocrats-turned-politicians Supachai Panitchpakdi and Amnuay Virawan, president of Thai Military Bank and Executive Chairman of Bangkok Bank respectively as deputy Prime Ministers in charge of economic policy.

1988-1996 Financial Liberalization and loosening of capital controls

Between 1988 and 1996 Thailand's GDP growth averaged 9.4% per year. Experiencing such phenomenal growth pushed Thailand to embark on ambitious plans to increase their political and economic role both regionally and globally. The backbone of

[29] Phongpaichit & Baker, 1997 p.360

this economic planning was financial sector liberalization. For Thailand a liberalized financial sector would increase competition and create efficient capital markets. An efficient financial system would, in-turn allocate capital more effectively. In Thailand's booming economy the government wanted the financial sector to drive profits into promising sectors of the economy. Externally, Thailand wanted to make Bangkok a financial hub. With the transfer of Hong Kong back to China coming up in 1997 becoming a financial hub seemed possible.

Under Chatichai Thailand took its first step towards financial liberalization. Liberalization was broken into stages to slowly allow more competition in the financial sector. Each stage would make the sector more competitive, thus more sophisticated and ultimately more efficient. Breaking up liberalization into stages allowed banks time to prepare competition especially from foreign banks.

The Bank of Thailand started by loosening regulations on interest rates. In 1989 and again in 1990, they removed interest rate ceilings on time deposits.[30] Interest rate ceilings protected bank profits by guaranteeing the banks a spread between deposits and loans (more below). Eliminating ceilings allowed banks to compete for new deposits by offering higher interest rates to attract more deposits. Time deposits are similar to bonds because there is a set maturity date. The depositor cannot withdraw the funds until the time deposit has reached maturity. In 1990, "the most popular instrument in the Thai banking system [was] the time deposit, which [commanded] an average share of 73% of banks' total deposits."[31]

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[30] Vichyanond, 2007 p.3
[31] Warr & Nidhiprabha, 1996 p.39

The Bank of Thailand also broadened the scope of activities banks could be involved in, for example, loan syndication, advisory services and refinancing.[32] Broadening the scope of activities encouraged banks to change their business model. Offering new services helped bring in more fee based income. The old model was developed in Thailand's protected banking sector where it was easy for Thai banks to make profits. The model was simple, they generated income from the spread—the difference between deposit and lending rates. Lending itself was quite simple. Half of all Thai banking credit in 1990 came from overdrafts.[33] Overdrafts are just credit lines offered to individuals or businesses. To compete internationally Thai banks needed to develop more sophisticated business models. Making profits off the spread is purely a volume driven business. In a protected market Thai banks had a secured share of the domestic market. In a competitive environment the spread would be squeezed by competition forcing banks to compete for customers and grow profits by increasing fee-based services.

In 1990, the currency market was liberalized under Article VIII of the International Monetary Fund (IMF). Commercial banks could conduct current account transactions without the pre-approval of the Bank of Thailand and citizens could open foreign exchange accounts with Thai banks and transfer money abroad for investments. Before Article VIII all current account transactions were channeled through the Bank of Thailand. The Bank of Thailand served as a control value for the inflow and outflow of capital. Article VIII removed the control value mechanism.

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[32] Vichyanond, 2007 p.3

[33] Warr & Nidhiprabha, 1996 P.39

The most noted change during the liberalization process was the establishment of International Banking Facilities of Bangkok (BIBF) in 1993. The BIBF allowed for the free (no transaction costs) borrowing and lending of Thai Baht with international currencies. BIBF further accelerated capital flows. Banks and finance companies that received exclusive BIBF licenses could trade currencies more freely and cheaply than before. They could also borrow money in dollars and make loans in Baht.

Thailand's growth in the 1990s was funded from abroad. The liberalization process made it easier to borrow internationally. From 1990 to 1996 non-FDI capital inflows averaged 8.4% of GDP and peaked in 1995 at 12.6% of GDP.[34] Banks were lending to government infrastructure projects, export growth sectors and real estate projects. Banks and finance companies took advantage of the BIBF licenses to borrow foreign currencies at low rates and then lend Thai Baht to projects at higher rates. This was profitable for the banks and finance companies because the spread between their cost of capital—borrowing from abroad—was low and the interest charged on their loans was high. Clearly this was a huge advantage to the firms that had secured BIBF licenses because of the option to borrow at international rates.

The main regulation metric for banks are capital adequacy ratios. Capital adequacy ratios require banks to retain a certain level of capital or cash expressed as a percentage of total bank assets. Thailand's adequacy ratios were aligned with the Bank of International Settlements (BIS) standards. Reporting requirements were also enhanced. Banks had to disclose balance sheet changes to the Bank of Thailand. The new requirements enabled the Bank of Thailand to monitor borrowing and lending behavior.

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[34] Vichyanond, 2007 p.23 foreign capital inflows to Thailand

Before IMF Article VIII and BIBF reforms, the Bank of Thailand could change interest rates, set reserve ratios and levy withholding tax on capital flows. These mechanisms gave the Bank of Thailand control over capital flows. The loosened regulations caused a spike in international borrowing. Thai banks began to borrow money internationally and lend money locally.

Financial liberalization was a problem for Thailand's monetary policy. The removal of capital controls strained Thailand's fixed currency scheme. Warr and Bhanupong questioned this conflict between unrestricted capital flow and Thailand's fixed currency scheme before the crisis in 1996, "Monetary policy operated effectively...over the period 1970-90...even through [Thailand] pursued a fixed exchange rate...The key to the paradox is the limited degree of [capital movement]." [35]

1997 looming crisis

By late 1996 it was clear that Thailand's fixed currency scheme was unsustainable. A drop in exports caused concern about a looming current account crisis. The current account deficit was not a cause for concern in itself. It was common in rapidly developing economies like Thailand's to draw foreign capital, in the form of direct investment or foreign borrowing, to fuel economic growth. Investment growth could not be funded by domestic savings alone and foreign capital filled the gap between the supply of domestic savings and the demand for credit. When export revenue fell Thailand knew it could not meet its foreign debt obligations.

Under the fixed currency scheme the Bank of Thailand had built up foreign reserves to control the price of Baht on international currency markets. But the massive

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[35] Warr & Nidhiprabha, 1996 p.171

capital inflows and simultaneous drop in exports put so much pressure on the Baht that it became impossible to maintain the currency peg. Had the Baht been floating, spikes in demand for foreign loans used to fund growth would have increased the cost of foreign currency until interest rate advantages were offset by the increase costs of foreign exchange. Any interest rate advantages should have been arbitraged away, but they were not because the currency was pegged to the U.S. dollar. Using foreign reserves to artificially stimulate demand for the Baht could only be sustained for short periods of time. A long persistent fall in demand for the Baht would drain foreign reserves. The strategy of using reserves to maintain a constant price was not sustainable in the long term.

Not only was Thailand drawing in foreign funds too quickly but international investors were intensifying the problem by selling short term loans more cheaply than long term loans. Even though foreign lenders knew that Thais were using short term international borrowings to lend long within Thailand the foreign lenders continued to lend short. This was a result of economic incentives for short term lending. Under international banking standards the capital adequacy ratio favored short term loans to developing countries. Loans to non-OECD countries received a 100% risk weighting if they were longer than one year, if they were less than one year the weighting dropped to 20%. Since asset risks are weighted depending on the type of loan, international financers could lend more money in real terms if the loan period was less than one year. Foreign lenders offered discounts for short term loans.[36] Thailand's financial sector had been borrowing short to take advantage of cheaper rates but they were still lending long. The

[36] Vichyanond, 2007 p.5

situation for Thailand was like the entire country taking an interest only loan with a balloon payment.

To stem capital inflows and correct the current account the Bank of Thailand should have floated the currency but instead they defended the peg in international currency markets. The vulnerable Baht attracted the attention of international currency speculators. Speculators knew that Thailand could not sustain such high levels of investment and current account deficits while also pegging the currency. By spring of 1997 they began speculative attacks on the Baht. The Bank of Thailand used the country's foreign reserves to buy up excess demand. Eventually the Bank of Thailand drained its foreign reserves defending the Baht. By June 1997 the bank was insolvent and on July 2nd 1997 the Baht was floated.

Failure to regulate banking sector during liberalization

The Asian financial crisis revealed how poorly managed the banks were. Despite the financial liberalization of the 1990s, the banking sector did not become more competitive or efficient. Since the reforms opened the door to a new supply of cheap capital it became clear that the control measures, BIS and reporting requirements, proved to be ineffective mechanisms for regulating the banking sector.[37]

Thailand's banks got richer, not more efficient, during liberalization. Overall economic growth and lack of real competition meant that the banks did not need to make efficiency gains to beat their competition.

The difficulty of regulating the banks is best captured by the story of the Bangkok Bank of Commerce (BBC). A 1991 audit of BBC revealed 26% of all loans to be

[37] Ammar, 2001; Vichyanond, 2007

substandard so the Bank of Thailand ordered BBC to increase its capital by 800m Baht. BBC delayed increasing their capital by rearranging the management structure. They appointed a family member who was also a staffer at the Bank of Thailand as Managing Director as well as placing two Bank of Thailand staff members to senior positions so they could delay the capital adjustment.

Even though the Bank of Thailand had ordered the capital increase, BBC's lending habits did not change. In 1993 a second audit showed that bad loans had increased to 39.6% of assets. In 1995 and 1996 to keep BBC afloat, the government bailed them out by providing capital injections from the FIDF and Government Savings Bank. BBC had relationship within the government, "BBoC is accused of extending poorly collateralized loans to borrowers for corporate takeovers. The bank's borrowers are said to have included politicians and two cabinet members, Newin Chidchob, deputy finance minister and Suchart Tancharoen, deputy interior minister. Both were among a number of ministers who have since resigned in political maneuverings among the coalition parties."[38] In all, over fifty billion baht was put into BBC.[39] The scandal was finally exposed in May 1996 when an opposition party member broke the news of BBC loans to politicians. Within one week the bank was taken over by the Minister of Finance.[40]

The Bank of Thailand and the Ministry of Finance were unable to enforce changes in the behavior of the Bangkok Bank of Commerce. The Minister of Finance, Surakiart Sathirathai had to resign because of the BBC debacle. The Bank of Thailand knew of the troubles of BBC for many years before they intervened. Communication

[38] The Banker, 1996 July
[39] Phongpaichit & Baker, 2000 as cited by Hicken, 2001 p.179
[40] Ammar, 2001 p.19

between the government and BBC dragged on for five years before BBC failed. The Bank of Thailand was unable to maintain its autonomy and perform its duty of regulating the banking sector. BBC had protected itself by providing loans to politicians.

1997- Post crisis reforms

After floating the Baht in July 1997, the Thai economy had stopped growing and began to retract. By year end GDP growth was negative, the IMF had provided a rescue package and a new government was in office.

Capital flowed out of Thailand and billions of dollars left Thailand's banks. The capital outflow put pressure on banks' foreign exchange reserve ratios. Foreign exchange reserve ratios insured that banks had enough foreign cash to meet foreign debt obligations. The banks had calculated the ratios based on the fixed currency. When the Baht depreciated banks fell below their ratio requirements. Capital outflow of dollars combined with the weak Baht caused banks to pass off losses to debtors. They made debtors with dollar debts convert their borrowings into Baht which lessened the pressure on foreign reserve ratios. Banks had unloaded their currency exposure to their customers. But passing debt onto customers made it more difficult for customers to pay back their loans and subsequently triggered an acceleration of non-performing loans.[41]

Furthering the extent of the crisis was the mismanagement of banking asset risk. Borrowings were short and loans were long. Financial obligations to creditors were due before loans could be called in. There was no asset risk management—the process of aligning receivable accounts due dates with payable accounts due dates. This example illustrates the lack of sophistication of the Thai financial sector.

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[41] Ammar, 2001 p.30-35

The biggest problem was the high number of non-performing loans (NPL). There was a lag in accounting for all the NPLs because loans were classified as non-performing when principal and interest had not been paid for twelve months. Banks could carry bad loans for months or even years before disclosing them. Banks avoided reporting NPLs because writing down assets put pressure on capital requirements. Thailand's pre-1997 economy was forgiving to banks, profit growth diluted bad loans before they were reflected in the financials. But after the crisis when banks needed to call in loans to meet their own debt obligations borrowers could not pay, raising the number of NPLs and making the banks insolvent.[42]

The 1997 reforms were very comprehensive. The Bank of Thailand wanted to recapitalize the financial system. In the most extreme case recapitalization meant a bank had to wipe their books clean. A bank would then recalculate its asset portfolio and rebuild its balance sheet. Most banks were partially recapitalized, asset portfolios were recalculated, debt renegotiated and equity injected.

The government set up a debt restructuring committee, the Financial Restructuring Authority, to facilitate negotiation between creditors and debtors for outstanding loans. New loan terms included payback extensions, interest rate breaks and debt-equity swaps. Thai banks often resisted negotiating with debtors and instead tried to foreclose on collateral put up by the debtor firms. In the past banks held significant bargaining power over their debtors, but after the crisis the banks were financially weak and in many cases insolvent. It was difficult for the banks to realize that many debtor firms did not have any collateral to foreclose on.[43]

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[42] Ammar, 2001 p.30-35

[43] Vichyanond, 2007 p.6-13

The Bank of Thailand changed asset classification definitions and required loan loss provisioning for risky assets. Strict loan classification would force banks to better calculate the risk of assets; depending on each type of loan a different risk weight was applied. When the weights are spread across an entire asset base, the capital ratio adjusts accordingly. The definition of an NPL was also changed, loans were considered non-performing after just 90 days.

Every reform put pressure on capital adequacy ratios. To maintain capital adequacy ratios banks were forced to take capital injections. Capital injections were a contentious issue because they diluted equity and threatened ownership. Liquidity injections were clearly needed not just to maintain adequacy ratios but also to give banks cash to continue operations. The rise of NPLs had taken its toll on income. After turning negative in 1997 the consolidated return on assets of Thailand's commercial bank was -5.5% and -5.4% in 1998 and 1999 respectively. In an industry with normal asset returns of 1.3% many banks were financially ruined. The net profit loss in 1998 alone exceeded the cumulative gains made from 1991 to 1996.[44]

The government first liquidated finance companies and banks that were completely insolvent and as a result unable to raise capital. Assets from liquidated companies were divided into performing and non performing loans. The performing loans were then absorbed by state owned banks and the NPLs were sold to asset management companies (AMC). The AMCs were set up specifically to restructure bad debt after the crisis.

To expedite liquidity injections the government offered its own bail-out packages. Foreign ownership restrictions were also removed. Foreign investors could purchase a

[44] Vichyanond, 2007 - In 1998 Net profit loss was -355B baht; 1991-1996 net profits totaled ~300B baht.

100% stake of a Thai bank for up to ten years. It is interesting to note that not all banks took government packages. In an industry where private banks often wielded bargaining power over the government they opted for foreign partners. Banks saw that the crisis threatened their existence. The legal structure of the foreign ownership structure left Thai banks with the possibility of buying out their partner in the future.

Many banks felt government bailouts were too restrictive. The bailout package required that banks meet their loss provisioning requirement immediately upon receipt of the government liquidity injection. "Most privately owned banks did not take advantage of the capital injection program. The only two that did, the Siam Commercial Bank and the Thai Military Bank had traditionally been semi-public banks – the Crown Property Office had a large interest in the first and the armed forces in the second." If banks could raise liquidity injections on their own they were given until December 2000 to meet the loan loss provisioning requirements. [45]

Banks also tried to recapitalize by issuing shares. "It turned out that few banks resorted to the capital enlargement opportunities offered by the government, particularly the tier-1 option. This indicated that banks were reluctant to write down their capital in return for public money and accept the dilution of ownership that would ensue. Instead, they raised capital through the issuance of preferred stocks."[46] The banks did everything they could to retain ownership but the crisis was too severe, they were forced to take on partners just to survive.

[45] Ammar, 2001 p.32
[46] Vichyanond, 2007 p.9

Crisis dilutes banking sector ownership

The largest effect of the crisis for the banking sector was the shift in ownership structure. Eventually every bank took some form of liquidity injection and for the first time ever, local families were not in financial control of the banks, "out of the 15 banks operating in 1996, one was closed down, three were merged with government banks, two were taken over by the government, and three became foreign owned. The remaining banks have been struggling to recapitalize on their own."[47]

The ramifications of the ownership changes were significant. Banks no longer sat at the center of the Bangkok business. The crisis had, "[cut] a swathe through the domestic business class, destroying or weakening all of the bank-based conglomerates that had long dominated the domestic capitalist class."[48]

Thai banks bargaining power vis-à-vis the government was weakened, "[it was] the end of the control of the bank-based conglomerates that had been central for much of Thailand's capitalist development."[49]

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[47] Polsiri & Wiwattanakantang, 2006 p.315
[48] Hewison, 2006 p.97
[49] Hewison

	1996		2001		2002		2003	
	no. of banks	% of total assets	no. of banks	% of total assets	no. of banks	% of total assets	no. of banks	% of total assets
Government	2	25.1%	5	42.9%	4	43.9%	3	33.3%
Family	12	61.9%	1	9.0%	1	9.3%	1	9.9%
Foreign	0	0.0%	4	7.8%	4	7.5%	4	7.3%
Other	1	13.0%	3	40.3%	4	39.3%	5	49.6%
Total	15	1.00	13	1.00	13	1.00	13	1.00

Source – Asia Development Bank Institute

The table shows the banking ownership structure in Thailand before and after the 1997 financial crisis. Bank are classified as *government*, *family*, *foreign* or *other* if the largest shareholder owns more than 25% of shares outstanding. Banks categorized as *other* have broad ownership structures where no single party holds more than a 25% share of the bank. In 1996 family owned banks controlled over half the total banking assets. By 2003 we can see the asset shift to government banks and banks with diluted ownership structures.[50]

Three of the original big four banks, Bangkok Bank, Thai Farmers Bank (now Kasikorn Bank) and Siam Commercial Bank have board ownership structures and are in the other category. Although financial ownership is diluted, founding families still have multiple family members sitting on the board of directors. They have retained some control over the bank.[51]

[50] Polsiri & Wiwattanakantang, 2006 p.372
[51] Hewison; Polsiri & Wiwattanakantang, 2006

Even with family members still on bank boards, the dilution of ownership signaled the beginning of the end of Thailand's banking oligopoly. It was not the reforms that forced ownership changes in the banking sector but rather the depth of the financial crisis that crippled the banks to such an extent they needed to take partners just to survive.

2001 – Attempt to politicize private banks unsuccessful

The Thai government led by Chuan Leekpai was in office from 1997 just after the financial crisis until 2001 when elections were held. The Chuan government had implemented a rigorous restructuring program in accordance with the IMF bailout package. 1997-2001 was marked by a declining economy, tight budgets and cash strapped businesses.

Four years into the crisis, in 2001, an election was held and Thaksin Shinawatra, Thailand's richest businessman, was elected Prime Minister and his party, Thai Rak Thai, held a majority in parliament. It was the first time in Thai history that a prime minister held a majority in parliament.[52]

The 2001 election was the first under a newly drafted constitution in 1997. The constitution sought to stabilize Thailand's weak faction based governments. Parties had always been weak and politicians could easily switch between parties creating new coalitions. Voters were loyal to politicians rather than parties. The new constitution made it easier to build strong parties. Under Thaksin the state had been completely captured by business interests. "The advent of majority government has meant that Thaksin and Thai

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[52] Hicken, 2006 p.19

Rak Thai have been able to act more decisively than any of their elected predecessors to implement their preferred policies."[53]

Thai Rak Thai ran a very sophisticated campaign by creating a platform that appealed to multiple groups of voters. Most voters were rural but the Thai Rak Thai platform also appealed to big domestic business. Distressed companies were under threat of foreign acquisition. Thai Rak Thai wanted to wean Thailand's economy off its dependence on exports so it would not be so vulnerable to external shocks. Many businesses supported Thai Rak Thai for its protectionist ideology including banks. Chatri Sophonpanich of Bangkok Bank said, "he was personally confident [Thaksin] could resolve the country's economic woes...[Thai Rak Thai's] economic policies were also clear, he said, especially those barring the sale of the country's assets to foreigners, particularly commercial banks...He said the nation also needed to take a stand on liberalization and prevent foreigners from acquiring too many assets."[54]

After the election Thai Rak Thai began to make good on its campaign promises. One of their campaign promises was to implement an economic strategy, dubiously dubbed Thaksinomics by newspapers, to create and nurture an environment of entrepreneurship which would help Thailand's economy become more independent and strong.

To initiate their economic strategy Thai Rak Thai needed to kick start the economy. They wanted to expand credit so people would start spending again. The idea was that consumption based growth would create new opportunities for businesses. Thaksin immediately set out to convince the banks to start lending again. To nurture the

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[53] Hicken, 2006 p.19
[54] Bangkok Post, 2000

growth of an entrepreneurial environment Thai Rak Thai knew that capital had to be allocated to promising young companies. But the banks were still adverse to lending and still carrying large amounts of NPLs.[55]

Thaksin offered to buy NPLs from the private banks but they refused. They knew the stimulation strategy was risky and if it failed they would be saddled with more bad loans. Since the private banks refused to participate in the lending strategy, the government used the state banks to increase lending. They transferred 781 Billion Baht of NPLs from mostly state owned banks into the Thailand Asset Management Company (TAMC). The government claimed the TAMC was established only to restructure bad loans so banks could be freed to extent credit again. But the TAMC was subsequently accused of providing favorable loan deals for debtors. Several of those debtors were Thaksin supporters.[56]

With the bad loans off their books, state banks could start lending. The state banks, dominated by Krung Thai bank, began to make new loans. In 2002 and 2003 state bank lending increased by 112% and 96% respectively. Krung Thai accounted for 70% of all new loans in 2003.[57]

In 2004 Krung Thai reported a $1.1B increase in NPL growth. The disclosure sparked a public debate about Krung Thai's lending behavior. They had been accused of providing loans to political allies of Thai Rak Thai. The Bank of Thailand required Krung Thai to increase their capital. The Bank of Thailand also requested that Krung Thai's president not to be re-appointed. The central bank was successful in blocking the

[55] Phongpaichit & Baker, 2004 chap.4

[56] Phongpaichit & Baker, 2004 chap.4

[57] Phongpaichit & Baker, 2004 chap.4

reappointment of Krung Thai's president. Unlike the case of BBC, the Bank of Thailand was able to assert its regulatory role with Krung Thai Bank.[58]

By 2001 the banks were profitable again giving them the financial strength to resist Thaksin's requests. The party's economic strategy was contingent on extending consumer credit. Their only choice was to intervene directly by using state banks to increase lending.

Conclusion

Thailand's banking system has proved very resilient in the face of government and political pressure. The banks relative bargaining power in Thailand's political economy was a result of concentrated ownership, political organization and skillful lobbying. Banks were able to resist regulatory reforms because the Bank of Thailand could not counter the Thai Bankers Association. "When the Bank of Thailand tried to impose the prudential standard capital adequacy ratios in 1962, 1979 and 1992 the bankers negotiated for lower ratios and won every time."[59]

The government has not been able to regulate the financial sector. Three financial crises in 1979, 1984-87 and finally in 1997 exposed insider lending practices, corruption, poor management and accounting scandals. Yet, despite these scandals the Bank of Thailand repeatedly tried to bailout banks before closing them down. This set a precedent and created moral hazard for banks.[60]

[58] Various news sources
[59] Polsiri & Wiwattanakantang, 2006 p.347
[60] Ammar, 2001

The Asian Development Bank concluded in a 2006 report, "We found that market discipline to be ineffective in Thailand. The banking industry has been operating under an implicit guarantee that no bank would be allowed to fail."[61]

Two things appear to have made banking more competitive. The first, was the shift in bank ownership structure after the 1997 crisis. Bank's boards were no longer beholden only to family members, but also to large foreign partners. Many banks have hung on to their NPLs choosing to restructure themselves, even though it took longer, instead of unloading those NPLs on the government.

The second is increased foreign competition. After the banks refusal to extend credit under Thaksin, his administration allowed foreign investors to set up small loan lending businesses. This provoked the Thai banks to extend services like credit cards to small loan consumers.

Thailand's overall economic success has made banking sector reform difficult. The government lacks the capacity to enforce regulation. However, Thailand's banking sector is becoming more exposed to competition and as competition increases, the sophistication of Thailand's financial sector should also increase. Until the banks become more focused on business and less focused on politics they will remain inefficient. When it becomes more cost effective to invest in productivity instead of investing in political protection, Thailand's banks will be operating in the truly competitive environment that liberalization was supposed to bring about.

[61] Polsiri & Wiwattanakantang, 2006 p. 387

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